Bank of Canada Banque du Canada

Working Paper 2006-32 / Document de travail 2006-32

Governance and the IMF: Does the Fund Follow Corporate Best Practice?

by

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ISSN 1192-5434

Printed in Canada on recycled paper

2007-00412

Bank of Canada Working Paper 2006-32

September 2006

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The views expressed in this paper are those of the author.
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Acknowledgements

I would like to thank Graydon Paulin, James Haley, Robert Lafrance, John Murray, François Painchaud, James Powell, Chris Salmon, and Larry Schembri for insightful comments.

Abstract

The governance challenges facing the International Monetary Fund (IMF) are not simply limited to representation and voice, and the associated question of quota allocation. The author identifies governance issues that hitherto remained largely ignored by the literature and policy-makers alike. Specifically, he examines the governance issues that arise when (i) one or more shareholders hold controlling voting blocks, and (ii) principal-agent problems exist between the Executive Board and the Managing Director. Furthermore, these typical governance issues are compounded by the specific characteristics of IMF governance, such as consensus decision making, the lack of clear fiduciary duty on the part of the Executive Board, and the lack of separation between the Executive Board and the Managing Director. The author then attempts to quantify the extent to which the IMF's governance structure deviates from corporate best practice. Unsurprisingly, he finds that the IMF does not follow best practice. The author offers several proposals for governance reforms, including that the IMF should implement a form of "constrained discretion." Under this framework, the Executive Board would set the objectives and rules for the IMF on an annual basis. The Managing Director and the staff would be free to pursue these objectives, conditional on the rules. These respective reforms would improve accountability and hence the legitimacy of the IMF.

JEL classification: F3
Bank classification: International topics

Résumé

Les problèmes de gouvernance du Fonds monétaire international (FMI) ne touchent pas uniquement la question de la représentation et des voix des pays membres ou le dossier afférent de la répartition des quotes-parts. L'auteur souligne en premier lieu l'importance de dimensions restées jusqu'ici largement ignorées des chercheurs comme des décideurs publics. Il s'intéresse en particulier aux problèmes découlant de la présence (i) d'un ou de plusieurs actionnaires dominants et (ii) de l'existence de conflits d'intérêts du type mandant-mandataire entre le Conseil d'administration et le directeur général. En outre, il estime que ces problèmes classiques de gouvernance sont aggravés par certaines caractéristiques du mode de gestion du FMI, notamment par la prise de décision consensuelle, par le fait que l'obligation fiduciaire du Conseil d'administration soit équivoque et par l'absence de démarcation entre le mandat de ce même Conseil et celui du directeur général. L'auteur tente dans un second temps de mesurer les divergences qui séparent la structure de gouvernance du FMI du modèle prôné par les entreprises.

Bien entendu, les données lui confirment que le FMI ne suit pas des pratiques optimales de gouvernance. L'auteur avance quelques pistes de réforme, en souhaitant par exemple voir instaurer au sein du FMI une forme d'encadrement du pouvoir discrétionnaire du directeur général. Dans ce cadre, le Conseil d'administration fixerait les objectifs et les règles de l'institution pour l'année. Le directeur général et son personnel auraient la latitude voulue pour poursuivre les objectifs énoncés, mais dans le respect des règles. Les réformes renforceraient la responsabilité du FMI et accroîtraient d'autant sa légitimité.

Classification JEL : F3
Classification de la Banque : Questions internationales

1. Introduction

The ongoing Strategic Review of the International Monetary Fund (IMF) should provide the opportunity to assess the IMF's role, functions, and governance.[1] However, despite the apparently strong interest in the Strategic Review process by the IMF, G-7, G-20, and other interested groups, little actual reform has been proposed. In fact, most of the official discourse maintains that the IMF is still *the* key instrument to promote global financial stability, and that its role as a centre of multilateral coordination, surveillance, advice, and as a provider of *temporary* finance, should continue largely unchanged.[2] Similarly, while admitting that some governance issues exist, particularly in the context of Argentina, the assessment of IMF governance is surprisingly sanguine (De Rato 2006). Most discussions focus on the question of quota allocations, and generally ignore reference to the equally important governance question of how decisions are made. Overall, the current state of the IMF Strategic Review is that the IMF should simply continue to do what it does, and in fact suggests an even greater role in terms of surveillance, lending, and its involvement in low-income countries (Truman 2006).[3]

The Strategic Review does not sufficiently acknowledge the fundamental changes that have occurred since the IMF's inception in 1944. The IMF no longer operates in a world characterized by fixed exchange rates, low levels of international capital flows, and limited financial sector development, and consequently, the IMF is no longer a provider of *temporary* finance to offset *temporary* balance-of-payments problems to its members, any of whom could be on either side of the balance sheet. Rather, the IMF now operates in a world of flexible exchange rates and highly integrated and sophisticated global capital markets, and has subsequently become a long-term lender to a group of serial borrowers. This evolution has coincided with the emergence of a distinct group of IMF creditors (developed countries) and IMF borrowers (emerging-market and developing countries), and countries that have flexible exchange rates and those that have fixed exchange rates, respectively.[4]

While the environment in which the IMF operates, the pattern of IMF lending, and the characteristics of its borrowers have evolved dramatically since the 1970s, the IMF's governance structure has remained static. The governance challenges facing the IMF are not simply limited to representation and voice, and the associated question of quota allocation; rather, this paper identifies governance issues that hitherto remained largely ignored by the literature and policy-makers alike. Specifically, I examine the internal

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[1] The Strategic Review was initiated in 2005 in order to examine the objective, role, and operations of the IMF. See IMF (2005) for a brief description of the mandate of the review.

[2] Recent speeches by Mervyn King (Bank of England), and Tiff Macklem and David Dodge (Bank of Canada), are notable exceptions.

[3] The IMF would actually expand its activity with respect to its involvement in low-income countries, surveillance, and crisis resolution.

[4] Moreover, the creditworthiness of the typical borrower has deteriorated over time, and this development, in combination with the longer lending terms, has potentially serious implications for the IMF's balance sheet. The implementation of a simple model of expected credit loss suggests that the IMF is bearing a greater degree of risk than before (Felushko and Santor 2006).

governance of the IMF: the structure and process of how decisions are made. First, I identify the governance issues that arise when one or more shareholders hold controlling voting blocks. In particular, the existence of controlling block shareholders may lead to suboptimal governance outcomes, since the objectives and interests of the controlling shareholders may not necessarily reflect the global interests of all shareholders. Second, I examine how governance is further complicated by the potential principal-agent problems between the Executive Board and the Managing Director. Since the Executive Board is not homogeneous in its objectives, it is often difficult for the Managing Director to interpret the overall mandate of the Board. Consequently, the Managing Director may pursue the objectives of only a subset of the membership, or alternatively, his or her own initiatives. In either case, the Managing Director may often pursue policies and actions that are not socially optimal. Third, I explore why these typical governance issues are compounded by the specific characteristics of IMF governance, such as consensus decision making, the lack of clear fiduciary duty on the part of the Executive Board, and the lack of separation between the Executive Board and the Managing Director. Consequently, these features of IMF governance contribute to a lack of accountability for IMF decision making. Using a framework drawn from corporate finance, I attempt to quantify objectively the extent to which the IMF's governance structure deviates from corporate best practice. Unsurprisingly, I find that the IMF does not follow best practice.

Despite the apparent prevalence of these governance challenges, few of these concerns have been addressed within the current Strategic Review process. And unsurprisingly, specific governance reforms in the past have been few and far between. The consequences of inaction are potentially severe and are to some extent already being realized. Many members feel that the decision-making process at the IMF continues to appear to be unduly influenced by its controlling shareholder(s), and that decisions are often driven more by political considerations than by sound economic analysis. Consequently, the IMF has begun to lose its credibility. This loss of credibility could potentially lead to an environment where some members begin questioning their continued active participation in the IMF.

Failure to reform the internal governance structure of the IMF would also affect many of the current proposals for its future role that critically depend on it being seen as a politically independent institution. For instance, the current environment of global imbalances has prompted many to argue that the IMF should be more actively engaged in multilateral surveillance (King 2006 and Dodge 2006). A key element of this proposal is the notion that the IMF will be an impartial and unbiased "umpire" of the international monetary system, ready to engage in "ruthless truth telling" to its members with respect to their exchange rate, fiscal, and monetary policies. The ability of the IMF to engage in a meaningful multilateral surveillance role would be compromised, however, if its governance structure did not allow for independent, and therefore non-politicized, analysis. More generally, any future reforms of the IMF, and its subsequent ability to be a truly effective international institution, will be meaningful only if its internal governance structure is appropriately constituted. That is, irrespective of the current and future roles of the IMF, can governance reforms be identified that will contribute to its effective functioning? Given that the IMF's mandate has changed dramatically

throughout its history, and will most likely continue to do so in the future, it is critical that the governance structure of the Fund be appropriately constituted. That is, decision making at the Fund should accord with corporate governance best practice: it should be transparent, accountable, and legitimate.

In light of these governance challenges, and their importance to the future of the IMF, I offer several proposals for governance reforms. The underlying principles of these reforms draw on concepts that are fundamental to modern central banking: clear objectives, transparency, accountability, and legitimacy. These principles can be operationalized at the IMF through the implementation of "constrained discretion." Under this framework, the Executive Board would be non-resident, charged with the responsibility to set the objectives and operational constraints for the IMF.[5] The Managing Director and the staff would be free to pursue these objectives, conditional on the constraints. The Executive Board would therefore be removed from the day-to-day running of the IMF and would meet (on a quarterly basis) only to review the performance of the Managing Director and the staff. This would allow the Executive Board to focus on more strategic elements of IMF governance.[6] Importantly, consensus decision making would be replaced with up/down voting, and other governance features that would help to ensure that agents internalize the costs (and benefits) of their decisions. In this way, these reforms would allow for the determination of clear objectives, greater accountability, transparency, and ultimately, legitimacy, thus leading to a more effective IMF.

The paper proceeds as follows. Section 2 briefly highlights the objectives of the IMF, and how these have changed since its inception, and section 3 describes the governance structure of the IMF. Section 4 then outlines the decision-making processes of the IMF and the potential governance failures that could occur. Section 5 quantifies the extent of these governance failures in terms of "corporate best practice." Section 6 then posits the potential consequences of failing to address these governance issues, and section 7 offers suggestions for governance reform. Section 8 concludes.

2. Objectives of the IMF

The evaluation of the IMF's governance structure naturally requires an assessment of its objectives in order to determine whether its governance structure is appropriately constituted. The objective of the IMF appears straightforward: the IMF seeks to provide a key public good through the promotion of international financial stability. Specifically, the IMF was created to spread the risks associated with idiosyncratic (temporary) shocks to members' balance of payments through short-term revolving credits, which encouraged members to eschew policies that might be *destructive of national and international prosperity*. Operationally, the IMF would provide temporary assistance to

[5] The constraints could include, for example, strict access limits, or ensure candid surveillance advice.
[6] The reallocation of responsibilities would also facilitate the existence of a non-resident Board, and would increase the degree of independence.

finance temporary shocks to its members; IMF members could be on either side of the balance sheet as either a lender or a borrower. The ability to provide temporary assistance naturally relied on the IMF's crucial role in surveillance: the timely recognition and assessment of evolving conditions in the respective countries' economies, and the global economy as a whole. In this way, the IMF is an institution that exists to mitigate and manage risk among its members for their mutual benefit.

The functioning of the IMF, as witnessed in the 1960s, was broadly consistent with the precepts set out above. In response to balance-of-payments crises, industrial countries often found themselves on either the creditor or debtor side of the balance sheet, and in terms of the latter, for only a short period of time. For instance, during the 1960s, Canada, France, Spain, Australia, New Zealand, and the United Kingdom all borrowed from the IMF, for terms of one to six years. The subsequent collapse of the Bretton Woods system, however, dramatically changed the environment in which the IMF operated. The industrial countries that were once on either side of the balance sheet became permanent creditors by the late 1980s. With the advent of flexible exchange rate regimes, well-managed macroeconomic policies, and the development of capital markets – and their ability to have continual access to these markets, even in times of crisis – industrialized countries no longer needed to access IMF resources.

At the same time, a shift in IMF lending practices occurred in response to the Latin American debt crises of the 1980s. In addition to offering short-term loans to mitigate the consequences of balance-of-payments crises, the IMF offered longer-term loans in order to facilitate structural adjustment and, following the collapse of the Soviet Union, systemic transformation. A key component of this type of lending was the imposition of strong conditionality. Similarly, the IMF's response to the financial and capital account crises of the 1990s reinforced this trend of long-term financing, albeit unintentionally in the context of "exceptional access." Countries such as Brazil, Argentina, and Turkey accessed IMF resources in even greater amounts for longer terms. The switch to providing long-term finance is clearly evident in the data. For example, the 30-odd borrowers who accessed the General Resource Account in 2003 had, on average, obtained IMF resources for 12 of the last 15 years. Moreover, the average sovereign credit quality of this group of borrowers was Ba or below.[7] Essentially, to meet the needs of its members, the IMF has acquired the characteristics of a development bank, in order to provide long-term loans to repeat borrowers with poor macroeconomic policies and poor sovereign credit ratings.[8] While there may be some benefits or "public goods" associated with this development, this is clearly not the IMF's original mandate. In fact, its mandate evolved without any parallel changes in its governance structure.

The ongoing integration of capital markets, and the heterogeneity of exchange rate regimes amongst IMF members, has also raised the potential importance of IMF

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[7] Countries with sovereign credit ratings of Ba or lower (B, Caa) are considered to be "speculative" grade.

[8] One could argue that if the IMF's role is more akin to that of a development bank, then it should adopt the governance structure of the World Bank. I would argue, however, that it is the governance failures of the IMF that have led to its current role, and that its mandate should be refocused away from development-type lending.

surveillance, especially with respect to multilateral surveillance at the systemic level in order to identify the negative externalities that represent risks to the international monetary system, and for preventing and mitigating financial crises and contagion. However, IMF surveillance has not, generally speaking, engaged in the "ruthless truth telling" that would ensure that such surveillance would be effective. Rather, the IMF is often caught in a conflict of interest, given that it is also lending to the same countries to which it is providing surveillance, and thus surveillance reports tend to be overly optimistic about such issues as debt sustainability and growth forecasts. Similarly, the IMF has also been reluctant to enforce the "rules of the game" with respect to exchange rate surveillance.[9] For example, the special consultation mechanism that was designed to address instances of currency "manipulation" has not been used in over 17 years (Goldstein 2005), nor has it been broadened to include analysis of member country policies that generate significant negative externalities in the international monetary system.[10] Consequently, IMF surveillance over the international monetary system and its member countries lacks credibility, and is therefore rendered less effective, preventing the IMF from achieving its goal of promoting international financial stability.[11]

These developments raise a simple question: have the nature of IMF borrowers, the state of the global economy, and the objectives and implementation of IMF surveillance and program lending changed too radically for the governance structure that was inherited from the pre–Bretton Woods era? The consequences of these trends should not be underestimated. If the aims and objectives of the membership diverge too greatly, some members may choose to "opt-out" of the IMF. For example, the accumulation of large amounts of foreign reserves would suggest that China and other East Asian countries are self-insuring against future crises instead of relying on the IMF (Gosselin and Parent 2005). Could this move to self-insure reflect the fact that these countries do not feel that the IMF has adequately represented their interests? Similarly, many borrowing countries have opted for early repayment in order to escape the influence of the IMF (for better or for worse). It is with these concerns in mind that I will assess the governance structure of the IMF.

3. Governance Structure of the IMF

The governance structure of the IMF reflects, in many ways, the co-operative nature that underpinned its founding.[12] There are five broad categories into which the IMF's governance structure is organized: the Board of Governors, the Board of Executive Directors, the Managing Director and the staff, the Independent Evaluation Office, and the International Monetary and Financial Committee (see Figure 1). Each will be described in turn.

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[9] While the IMF does not have many means to "enforce" the "rules of the game," it can call out members for poor policy behaviour.

[10] Presumably there have been some instances of exchange rate "manipulation" during this time.

[11] Given the recent concern over global imbalances, there is presumably a greater need than ever before for effective surveillance.

[12] This descriptive section follows van Houtven (2002).

3.1 Board of Governors

The Board of Governors is the highest decision-making body of the IMF and oversees the IMF's broad policy-formation process. The responsibilities of the Board of Governors include accepting new members, setting the income target of the IMF, and decisions with respect to quota increases. Every member of the IMF has a Governor on the Board and there are currently 184 members. Voting rights, unlike many other international bodies, are not based on one member–one vote. Rather, voting power is roughly allocated on the basis of quota, and the United States and the other industrialized countries hold the majority of votes.[13]

3.2 Board of Executive Directors

The enormous size of the Board of Governors naturally implies that most decision making would be delegated to the Board of Executive Directors, and the Articles of Agreement (IMF 2006) defers to the Executive Board all those powers not explicitly reserved for the Board of Governors. Consequently, considerable power has accrued to the Executive Board over time. The Executive Board initially consisted of 12 directors, but now totals 24 directors. Of the 24 directors, five are automatically allocated to the largest five members by quota: the United States, Japan, Germany, France, and the United Kingdom. China, Russia, and Saudi Arabia are also allocated one director exclusively. The remaining directorships are based on country groupings, with the largest country often electing the director. For example, the constituency that consists of Antigua and Barbuda, the Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland, Jamaica, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines, is represented by the Canadian director. The constituency must vote as a block: individual countries within the group cannot vote differently. The Executive Board sits in "continuous session" and its primary function is to approve and/or initiate the policy actions of the Managing Director and the staff.

3.3 Managing Director and Staff

The Managing Director and the staff of the IMF play the primary role in formulating and implementing the policies of the IMF. The Managing Director manages the day-to-day operations of the IMF based upon the recommendations and advice provided by the staff. The Managing Director also plays an important role in guiding the IMF, by setting the

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[13] Quota is tied to economic size, openness, and the volatility of exports, and determines the voting power, contribution, and, to some extent, the lending access limit of member countries. It is important to note that voting rights are based on actual quotas and not calculated quotas. Calculated quotas often differ substantially from the actual quota allotted to each country. Given that there is a fixed amount of quota at any point in time, changes to quota allotments are essentially a zero-sum game that includes political trade-offs within the IMF's membership. Naturally, the United States and the other industrialized countries hold the majority of votes in the Board of Governors. The United States holds roughly 17.4 per cent of the votes, the G-7 accounts for 46.2 per cent, and industrialized countries account for over 61 per cent of all votes.

agenda for Board of Governor meetings and summing up the Board's discussion. The Managing Director (or the Managing Director's deputies in his or her absence) also chairs most meetings of the Executive Board. In this capacity, the Managing Director exerts considerable influence over the IMF's policies and program implementation. The Managing Director is appointed by the Board, but in practice the appointment process relies upon an informal arrangement among the G-7 countries: the head of the World Bank is American and the Managing Director of the IMF is European.

The staff of the IMF works within a highly structured and hierarchic bureaucracy. Staff members are on the "frontline" of surveillance and policy implementation: mission reports, Article IV country surveillance, research, and other operational papers form the basis on information used by the Executive Board (van Houtven 2002). However, the structure of the IMF is such that all reports by staff must pass through the Policy Development and Review Department in order to ensure that they adhere to IMF standards and maintain "even-handedness." Naturally, this process has been criticized for leading to homogeneity of thinking, and thus reports to the Executive Board that often lack the necessary frankness. Nevertheless, the close proximity of Executive Board members to staff often allows dissenting views to be aired informally. The staff itself, while technically to be drawn from the widest possible distribution of its members, consists overwhelmingly of U.S.-trained PhDs.

3.4 Independent Evaluation Office

A recent addition to the IMF is the Independent Evaluation Office (IEO). The IEO was created in 2000 in order to provide independent "arm's-length" assessments of IMF program lending, policy advice, and feedback on governance issues. The IEO has been very active, producing several reports that are highly critical of the IMF's activities.[14] In particular, the IEO's evaluation of the IMF's programs in Argentina throughout the 1990s highlights many governance and policy failures. While the creation of the IEO is a major step forward in improving the governance of the IMF, its eventual impact on future behaviour is still unknown.

3.5 International Monetary and Financial Committee

The International Monetary and Financial Committee (IMFC) was initially known as the Interim Committee. The Interim Committee was formed in 1974 to assist in the creation and governance of a new international monetary system in the aftermath of the abandonment of the Bretton Woods system of fixed exchange rates, worldwide recession, and the OPEC oil-price shock. Membership consisted of the G-10 plus some emerging market countries.[15] The role of the Interim Committee was to advise the Board of Governors on broad policy issues such as the "adaptation of the monetary and financial system" and "developments in global liquidity" (IMF 2004). The IMFC meets twice a

[14] See IEO (2003, 2004a,b) for examples of their work.

[15] The membership of the G-10 (G-7 plus Belgium, the Netherlands, Sweden, and Switzerland) also encompasses the countries that constitute the IMF's backup creditors for the General Arrangements to Borrow (GAB).

year and consists of individuals who are also Governors of the IMF.[16] This usually means that IMFC members are ministers of finance or central bank governors.

4. Decision Making at the IMF

There are two distinct aspects to IMF governance: voice and representation, and how decisions are made. Given that many other researchers and policy-makers have already made proposals with respect to the former, I focus on the other distinct issue of how decisions are made at the IMF. Moreover, I would argue that the governance issues highlighted in this section would not necessarily be mitigated even if quota reallocation did occur. This section examines decision making at the level of the Board of Governors and the Executive Board. Each will be considered in turn.

4.1 Board of Governors

The decision-making process of the Board of Governors reveals the preferences of its founders: the governance of the IMF, in terms of broad policy matters, will need to command the broadest support of its members. The Board of Governors meets yearly and votes on an up/down basis on key policy issues. For the critical decisions, such as the suspension of voting rights for members that are in non-compliance with IMF programs, or the process of compulsory withdrawal, supermajorities of 85 per cent are required.[17]

4.2 Board of Executive Directors

The size of the Board of Governors means that most of the day-to-day governance of the IMF would fall to the Executive Board. The Executive Board meets as "needed," which in effect has meant an almost continuous session. Decision making at the Executive Board is determined by "consensus." In this process, the Managing Director (or the deputy), who chairs the Executive Board, takes an informal "sense" of the members and determines whether consensus has been reached. This standard implies that unanimity is required, but often a "large majority" is sufficient. When consensus cannot be reached, up and down voting is conducted. However, this rarely happens in practice. Rather, members can demand that their objections be made part of the record. In this instance, phrases such as "this should not constitute a precedent" or "the staff should not do this again" are included in the decision (van Houtven 2002).

4.3 Executive Board and Managing Director: Governance Issues

The relative importance of the Executive Board necessarily implies that the majority of my analysis will focus on the governance issues confronting this part of the IMF's governance structure. The process of decision making at the Executive Board level

[16] The IMFC also allows for the deputies of the IMFC countries to meet (regularly).

[17] For more mundane IMF business, including quota reviews, the allocation of special drawing rights, and the size of the Executive Board, 85 per cent supermajorities are also still required, although some decisions need only 70 per cent majorities. The number of decisions that require supermajorities has risen over time.

suffers, in principle, from the standard governance issues facing most firms. First, the existence of a controlling shareholder(s) may lead to suboptimal governance outcomes, since the objectives and interests of the controlling shareholder(s) may not necessarily reflect the global interests of all shareholders. Second, principal-agent problems may exist between the Managing Director and the Board, since the incentives of the Managing Director may not be aligned with the Executive Board.[18] Each will be considered in turn.

(i) Governance issues: Controlling shareholders

The first governance issue is that one or more major shareholder(s) may attempt to extract private benefits from exercising control.[19] For example, if private benefits to control exist, then the incentives and actions of the controlling shareholders could differ greatly from other shareholders. The ability of controlling shareholders to pursue their interests in this instance can be furthered by the compliance of the Managing Director.[20] Thus it is often the case that the Managing Director and the staff lack the ability to say "no" in the face of controlling shareholder interference in the day-to-day running of the IMF. The reason for this degree of compliance may be the desire to please a major shareholder in order to "repay": the Managing Director feels obliged to accommodate the wishes of the major shareholder(s) that appointed him or her. Consequently, a *quid pro quo* exists that may result in policy choices that are not necessarily consistent with the objectives of all shareholders. Similarly, "log-rolling" may exist between major shareholders, in which each member agrees to promote the other's interest, in return for similar considerations in the future. And lastly, since the duties and responsibilities of the Executive Board are not clearly delineated, a controlling shareholder(s) may push the Executive Board to undertake decisions that should be considered by the Board of Governors.

(ii) Principal-agent problems: Managerial discretion

The second governance issue is best characterized as a principal-agent problem, in that the Managing Director may not undertake actions that are in the best interest of shareholders. Since the Executive Board is not homogeneous in its objectives, it is often difficult for the Managing Director to interpret the overall mandate of the Board. Consequently, the Managing Director may pursue the objectives of only a subset of the membership, or alternatively be driven by personal initiative. In both cases, the Managing Director may also be motivated by "empire building" instincts. For example, the Managing Director may desire to broaden the policy mandate of the IMF through the

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[18] The same type of principal-agent problems exist between the Board of Governors and the Managing Director, but this discussion will limit itself to the Executive Directors and the Managing Director.

[19] A large corporate finance literature has shown that control of a firm can be exercised when a major shareholder possesses as little as 10 per cent of the voting rights. One of the primary motivations for holding a controlling block is that the shareholder can receive private benefits. In fact, controlling blocks often trade at significant premiums, suggesting that there are private benefits to holding such blocks.

[20] Evidence of this can be seen in the fact that the Managing Director and the staff have often been viewed as insufficiently independent in the policy process: for example, the IMF may be pushed into areas where they might not want to go, such as policy advice on anti-money-laundering activities.

provision of larger loans to more countries for longer terms.[21] Similarly, the Managing Director may desire to move the IMF into new areas of responsibility (such as promoting international trade). The ability of a subset of the Executive Board to restrain the Managing Director, however, may be compromised by the fact that proactive reactions to the initiatives and actions of the Managing Director can be easily vetoed by small coalitions within the Executive Board. And lastly, the lack of separation between the Executive Board and the Managing Director creates further governance issues, since many Executive Board members rely heavily on the Managing Director and staff for information and advice.[22]

4.4 Further governance challenges

These typical agency problems would normally be mitigated by an effective Executive Board. In the case of the IMF, however, mitigation of the governance challenges described above is complicated by several important characteristics of the IMF:

(i) The Executive Board is not independent. Its "fiduciary duty" is not clear, since Executive Directors represent their respective political capitals and may not act in the "best interests" of all shareholders.

(ii) The Executive Board is not homogeneous. Unlike many private sector boards where shareholder interests would be aligned by the profit motive, this is not necessarily true in the case of the IMF (Plumptre 2004). The interest of developed-country Executive Directors (creditors) may differ substantially from that of developing-country Executive Directors (debtors).

(iii) Some IMF members possess ownership stakes that could be categorized as "controlling blocks," with a divergence between ownership and control. That is, some Executive Directors have influence well beyond their simple ownership (quota) share. This is t e of the United States in particular, given its veto power. Consequentl , the interests of some Executive Directors may diverge greatly from other shareholders if there are private benefits to exercising control.

The consequence of these features of the IMF's governance structure is that the actions of a "controlling shareholder," or those of the Managing Director (in conjunction with a subset of the shareholders), may not be constrained by the Executive Board. These governance issues are further compounded by the decision-making process of the IMF: decisions are made by consensus, and there is a lack of accountability. The source of this lack of accountability, unsurprisingly, lies within the consensus model of decision making, and the close working relationship between the Managing Director and the Executive Board.

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[21] The IMF also suffers from a "lending" culture, wherein staff are promoted on the basis of their promotion of large lending programs.

[22] Moreover, the Executive Board often defers to the Managing Director's authority.

4.5 Accountability and consensus decision making

The consensus model of decision making at the Executive Board level, combined with the considerable influence of the Managing Director, blurs the lines of accountability at the IMF. Simply, the need to find consensus disallows free and open voting, even when there are substantive disagreements among shareholders. This inability to attribute responsibility to either the Managing Director or the Executive Board is compounded by the perception that Executive Directors themselves are not allowed to make decisions on an autonomous basis, but must instead reflect the directives of their political masters. That is, it is not clear what the fiduciary duty of the Executive Directors entails: is it to the political capital, or is it to the IMF and its entire membership? An added complication is that the Managing Director can be perceived to be too pliant to the demands of one or more major shareholders who constitute a controlling block. Consequently, it is not often clear where accountability lies: with the Managing Director, the Executive Director of a particular country, or with the political capitals themselves.

This inability to attribute responsibility for IMF actions is further complicated by the added layer of the Board of Governors. Presumably, the Board of Governors oversees the broad policy direction of the IMF, and so responsibility may ultimately fall within its purview. But the size of the Board of Governors rules out directly attributable responsibility to a particular set of countries.[23] Thus, where the ultimate responsibility lies for a particular policy decision is not directly observable, and accountability is a major problem. That is, the costs of policy mistakes are not internalized by the decision maker.

A clear example of how difficult it is to attribute program policy and outcomes is the occurrence of exceptional access lending. The simple fact that the Executive Board approved these programs, despite the violation of its own rules, suggests that the two competing hypotheses cannot be identified separately. On the one hand, a controlling shareholder, in conjunction with a compliant Managing Director, can engage in policies that do not represent the best interests of all shareholders. On the other hand, the Managing Director and the staff can make managerial decisions that are approved without the necessary fiduciary oversight. In either case, if these programs are ineffective or fall into arrears, the apportioning of responsibility will not be clear. Is it the case that the Managing Director made an error in judgment that was approved by the Executive Board, or was the Executive Board willing to extend exceptional access (possibly against the wishes of the Managing Director), despite the distortions its actions would have in markets, and the potential risks to the forward-commitment capacity and balance sheet of the IMF? If it is the latter case, were the motives of the Board in the interest of all shareholders, or did they reflect the political interests of certain members?

Without a doubt, the consensus model of decision making impugns the ability of member countries, and their constituencies, from attributing the consequences of IMF program decisions to the appropriate level of decision maker at the IMF. The actions taken by the

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[23] In a different vein, many view this arrangement as a means for the G-7 countries, and the United States in particular, to control the agenda of the IMF without taking direct responsibility.

IMF can alternately be attributed to the Managing Director, Executive Board, and/or certain political capitals, and thus the costs of poor policy formation and implementation are not internalized.

5. IMF Governance and Corporate Best Practice

The examination of the IMF's governance structure suggests that there are several potential governance failures: the existence of controlling block shareholders, excessive managerial discretion, and a lack of accountability. But more generally, how does the IMF rank in terms of corporate best practice? That is, can one quantify these governance failures? The recent spate of corporate governance scandals in North America and Europe has spawned a growing literature on the effects of corporate governance structures on firm-level performance.[24] The aim of these studies is to measure whether a corporation follows corporate "best practice." For example, Gompers, Ishi, and Metrick (2003) construct a governance index in order to measure the extent to which managers can maintain the status quo in the face of shareholder activism. That is, does the corporation have the qualities of a democracy, where shareholder activism is possible, or does it have the quality of a "dictatorship," a situation where management, or a major shareholder, can effectively control the institution for their own benefit?

5.1 Evaluating corporate best practice

In order to evaluate whether the IMF governance articles follow corporate best practice, I apply the methodology of Gompers, Ishi, and Metrick (2003) to the IMF's governance articles. I readily acknowledge that the use of measures of corporate governance best practice may not be entirely appropriate, since the IMF is an international financial institution and many of the metrics of corporate governance therefore do not have a direct mapping to the IMF. Moreover, I recognize that the IMF does not exist simply to maximize shareholder value, but is charged with the provision of a public good.[25] Nevertheless, the application of these metrics of corporate governance best practice is still relevant, and can provide a useful guide for evaluating the IMF's governance structure.[26]

The governance index of Gompers, Ishi, and Metrick categorizes provisions in a corporation's governance rules that prevent shareholder activism. The governance index includes 24 measures, although only a subset are applicable to the IMF. For each measure, a 1 is recorded if the provision exists, and 0 otherwise. The measures assume that the existence of the provision indicates lower shareholder activism. Therefore, the higher the number, the more likely that the firm is a "dictatorship" and not a

[24] For instance, the Enron, WorldCom, and Parmalat corporate scandals are excellent examples of how a lack of governance oversight led to poor performance and hence was detrimental to shareholders.

[25] This public good, presumably, would be of interest to all shareholders, and thus shareholders' interests should be aligned to some extent.

[26] While the IMF is not a private corporation, I would argue that it would benefit greatly from undertaking many of the governances learned from its private sector counterparts.

"democracy." The appendix lists the provisions that are assessed, the average percentage of large, publicly traded U.S. firms in 1998 that had such provisions, and whether the provision is relevant for the IMF. I then determine whether the provision is in effect at the IMF.

5.2 Summary of the governance index application to the IMF

The application of the Gompers, Ishi, and Metrick measures of corporate governance reveals that the IMF's governance provisions tend towards those of a "dictatorship." Of the eleven relevant provisions, the IMF scored 8.5 (see Table 1). When the same eleven measures were applied to a sample of large, publicly traded firms in the United States between 1990 and 1998, the average score was 2.7. This would suggest that the IMF's governance structure tends to be more "dictatorial" than its private sector counterparts across these measures, and, consequently, that the IMF's governance articles do not tend towards corporate best practice.

Table 1: Governance Index Measures

Subindex	Provision	Description	IMF score*
Delay	Classified (staggered) board	Directors are placed into different classes and serve overlapping terms	1
	Special meeting limitations	Shareholder meetings require additional levels of support	1
	Written consent	The need for unanimous consent	0
Protection	Director indemnification contracts	Directors are immune to prosecution and lawsuits from shareholders	1
	Liability	Limits on directors' personal liability for breaches of duty of care (duty of loyalty)	1
	Severance	Assurance of position of executives does not depend on changes in control	0
Voting	Bylaw and charter	Supermajorities required to amend governing amendments	1
	Lack of secret ballot	Confidential voting	0.5
	Supermajority	Supermajorities of greater than 70 per cent required	1
	Unequal voting rights	Some shareholders limited in their voting rights	1
Other	Directors' duties	Provisions allow directors to consider the needs of constituents other than shareholders	1

* IMF score is from author's calculations. Lower score indicates better governance structure.

The practical consequences of this governance structure are that it is difficult for minority shareholders to easily effect change at the IMF. Rather, institutional inertia may be dominant. That is, while change may occur, it would tend to be incremental and would represent decisions made by the controlling block shareholders and/or the Managing

Director. Simply, the governance structure of the IMF is well suited to maintaining the status quo.[27]

6. Consequences of Inaction

The consequences of the IMF's ongoing governance challenges can be fully assessed only when one considers the initial conditions under which it was intended to operate. The IMF was conceived as a co-operative institution: member countries joined the IMF under the presumption that they could be either a creditor or a debtor at any point of time. This co-operative function was complemented by a governance structure that reflected such relationships. Decision making was based on a consensus amongst a group of sufficiently like-type members. Given the probability that a country could be on either the creditor and/or debtor side of the balance sheet, voting behaviour was aligned appropriately. In this way, the IMF had the Rawlsian quality of the "veil of ignorance," wherein the incentives of each member were clearly aligned due to the uncertainty regarding each country's outcomes, and hence relative position within the IMF.

The governance structure of such an institution would be consistent with the consensus model of decision making, since consensus is easy to obtain when the objectives of the members are similar. Even in the presence of shareholders who held larger stakes than others, there is a high likelihood that the objective functions of all members would be aligned. But what are the implications for the governance structure of the IMF if members no longer believe that they will be on both sides of the balance sheet?

The consequences for the IMF due to the changing composition of its membership are profound. Whereas the co-operative contractual arrangement that was constituted in 1944 made sense since the membership was sufficiently homogeneous, this is no longer the case. Rather, if the IMF has evolved into an organization that consists of one group of debtors and one group of creditors, the incentives for the former will differ considerably from the latter.[28] Similarly, there are a group of countries with flexible exchange rates, and another group with fixed exchange rates. Consequently, the objectives may no longer be clear, and, in fact, the conflicting interests of the membership may lead to confusion over the IMF's objectives. This lack of clarity in the IMF's objectives would only be compounded by the governance challenges of the IMF. For instance, a controlling block shareholder would be more likely to pursue its interests at the expense of others. Similarly, the Managing Director may also claim "to know best" and pursue objectives that are not necessarily appropriate for all members of the IMF. In either case, the objectives of the IMF may no longer be clear, and also inconsistent with the objectives of the IMF's broader membership. In this instance, the IMF's legitimacy would be diminished in the eyes of its shareholders.

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[27] This is not to say that this is not a desirable outcome. There could be many negative consequences from excessive shareholder activism for an institution such as the IMF. Change induced by shareholders that occurs too frequently and idiosyncratically may not be the ideal governance model to consider.

[28] The problem arises due to the fact that the governance structure assumes that the member countries will be "equals." For instance, the Articles are very clear in the need for "uniform" treatment.

The legitimacy of the IMF is further compromised by its governance failures. In particular, if the decision-making process at the IMF continues to be unduly influenced by its controlling shareholder(s) and the Managing Director, and the decisions taken (for good or for worse) are neither transparent nor subject to the appropriate degree of accountability, then the IMF may begin to lose its credibility with its membership. That is, if the members of the IMF do not feel that the governance structure adequately accounts for their concerns, the IMF risks losing the support of its members.

The consequences of inaction are potentially severe, and are, to some extent, already being realized. The loss of legitimacy could potentially lead to an environment where some members begin questioning their continued active participation in the IMF, and, in the worst-case scenario, may consider exiting the IMF.[29] To some extent, this may already be occurring. For example, many Asian countries are self-insuring through reserve accumulation, rather than relying on the IMF in event of a crisis.[30] Similarly, Argentina and Brazil have opted for early repayment, in order to free themselves from IMF involvement in their domestic policy decisions. In both cases, member countries do not necessarily view the IMF as legitimate or credible, and do not view access to the IMF's resources as desirable.

Failure to reform the internal governance structure of the IMF would also affect many of the current proposals for the future role of the IMF. For instance, the current environment of global imbalances has prompted many to argue that the IMF should be more actively engaged in multilateral surveillance (King 2006, Macklem 2006, Dodge 2006, de Rato 2006). A key element of this proposal is the notion that the IMF would be an impartial and unbiased "umpire" of the international monetary system, ready to engage in "ruthless truth telling" to its members with respect to their exchange rate, fiscal, and monetary policies. The ability of the IMF to fulfill the objectives of an enhanced multilateral surveillance role would be compromised, however, if its governance structure did not allow for independent, and therefore non-politicized, analysis. Similarly, in terms of lending, the creation of strict access limits has meaning only if those limits are respected by the Executive Board, and not ignored for the sake of political expediency. More generally, any reforms that are instituted will be effective only if the internal governance structure of the IMF is appropriately constituted. Consequently, failure to address the governance challenges of the IMF could have serious consequences for its ability to remain an effective international organization.

7. Options for Governance Reform

I acknowledge the need to consider reforms in terms of voice, representation, and other aspects of governance. However, even if the quota issue is successfully resolved, the

[29] Or, less seriously, members may not take up future quota increases, thus effectively reducing the IMF's relevance.

[30] This is due to the fact that many Asian countries felt they were forced to bear too high a level of adjustment, relative to other IMF members who received more favourable treatment.

IMF still faces significant governance challenges. In fact, I would argue that simply reshuffling the quota deck will do very little to resolve the governance issues raised earlier. The ability of major block shareholder(s) to exercise effective control of the IMF will likely remain undiminished. Similarly, the heterogeneous nature of the Executive Board, the lack of clarity in the fiduciary duty of directors, and the convention of consensus decision making will continue to inhibit transparency and accountability. This section will therefore focus on the need for improving legitimacy, through providing a governance framework that will promote greater clarity of objectives, transparency, and, importantly, accountability.

7.1 The principles of modern central banking and constrained discretion

The organizing principles of governance reform can be drawn from the lessons learned from central banking. Specifically, modern central banking has emphasized that policy success depends on having clear objectives, coupled with transparency and accountability. In order to introduce clearer objectives, greater transparency, and accountability, I propose to introduce a modified form of constrained discretion at the IMF.

The notion of constrained discretion as an organizing principle for the IMF should be considered. Constrained discretion has successfully formed the foundation for the inflation-targeting policy framework of central banks in several countries, including Canada, England, and New Zealand. The idea behind constrained discretion is that the policy objective of the central bank is set out clearly in advance, and the central bank is then free to use its instruments to achieve that goal. The key is that in pursuing the objective, the central bank must follow policies that are time consistent: large policy deviations are discouraged, since they would not be compatible with the stated objective. One of the benefits of constrained discretion is that it encourages the appropriate level of transparency. At the same time, it allows for greater clarity in attributing accountability, since the objectives, constraints, and instruments of the central bank are clear. Some critics of this approach argue that constrained discretion implies a set of rules that, in some instances, may be too simple for the environment in which the central bank operates. However, constrained discretion does not necessarily imply such strict and simple rules: rather, there is still room for the central bank to respond to unanticipated shocks in the short term, so long as the longer-term objectives are met. But, ultimately, discretion is constrained by the fact that, in the medium term, the central bank must achieve its objective.

Constrained discretion could be instituted in the case of the IMF as follows. The Executive Board would clearly set the objectives and rules of the IMF. The objectives would include promoting international financial stability, while the rules would describe the modalities of multilateral surveillance, lending, and policy advice. Then, given the rules, the Managing Director would be free to pursue the objectives. A necessary part of this framework is that there must be a clear separation of the roles of the Managing Director and the Executive Board, in order to ensure transparency and accountability. The details of this constrained-discretion governance structure are considered below.

7.2 Separation of the Managing Director and the Executive Board

The central governance challenge confronting the IMF is the issue of transparency and accountability. At its heart is the need to be able to delineate where responsibility lies for a given program or policy outcome. To this end, several reforms can be considered. First, a greater delineation needs to be made between the Managing Director and the Executive Board, since the degree of interaction between them should be curtailed. A simple solution is to create a non-resident Board and to reduce the number of Executive Board meetings from the current "continuous" session to only a few times a year (perhaps quarterly meetings). Under this framework, the Executive Board would no longer be responsible for the day-to-day running of the IMF; rather, it would be responsible for the overall strategic direction and the constraints (or most likely just to review and/or enforce the existing limits) under which the Managing Director could operate. Second, to improve transparency and accountability, decision making at the Executive Board level would no longer be made by consensus; rather, all decisions would be subject to up/down voting. Thus, the Executive Directors would be accountable for the decisions made by the Executive Board. Importantly, the minutes of the Board meeting and the voting results would no longer be held secret for many years. Instead, Board minutes and voting records would be available almost immediately, much like FOMC meetings.

Lastly, in order to achieve better governance outcomes, the fiduciary duty of the Executive Directors must also be clearly defined. Executive Directors should exhibit greater autonomy and place more emphasis on the objectives of the IMF as an independent international financial institution. In this way, the Executive Directors would be responsible for achieving the interests of all shareholders, not just the narrow interests of their political sponsor. This fiduciary duty includes: maintaining the independence of the economic analysis that forms the foundation of surveillance, ensuring that access limits are obeyed, and that greater weight is placed on assessing threats to the balance sheet, and hence the financial integrity of the IMF.

7.3 The implementation of constrained discretion

Under constrained discretion, the Executive Board would set out the objectives of the IMF, and determine the appropriate set of instruments and rules. First, the Executive Board would set the objectives of the IMF. In this case, the IMF's objective would be to promote a market-based international financial system.[31] Then it would set out the instruments to be used to achieve this goal: multilateral surveillance, coupled with policy advice, and, in some limited cases, lending. Given the objectives and the instruments, it would then set out the rules. For instance, strict rules could be placed on the conduct of surveillance: the IMF would be obliged to report the findings of the staff and Managing Director, thereby ensuring that the analysis was not subject to political manipulation from the various constituents of the Executive Board. In this way, the IMF could engage in the "ruthless truth telling" that is required in order to make surveillance effective. Similarly, in terms of the lending, the Executive Board would clearly delineate an

[31] In my view, the promotion of a "market-based international financial system" would be consistent with the Articles of Agreement.

appropriate set of country-specific access limits that are tied to quota (as opposed to the current proposal for a precautionary lending instrument, which leaves considerable discretion for the allocation of additional resources to the borrowing country upon "review").[32] The aim of these limits would be to reduce the degree of discretion that can be exercised by the Managing Director.[33] Part of this process would include separate and independent assessments of the access limits by the heads of the Geographic, Finance, and Policy Development and Review departments (as recommended by the G-10 Working Group on IMF Finances).

In order to place further discipline on IMF lending, credit access limits could also be implemented in conjunction with risk-based credit-loss measures.[34] While the IMF holds precautionary balances on its balance sheet, it does not formally assess the risk against which these balances are held: the level of precautionary balances is set in an ad hoc manner. Instead, the IMF should utilize risk-based credit-loss measures, and the level of precautionary balances should be linked to these measures. There are two benefits to this approach: first, it would help to constrain managerial and Executive Board discretion; and second, it would help to ensure the integrity of the IMF's balance sheet. Setting limits on the level of credit risk would prevent overlending to poor credit risks.[35] The strict application of access limits should also help to mitigate moral hazard problems since country authorities and private investors would know, ex ante, the upper bound on IMF intervention.

The benefit of these rules is that it would dramatically improve accountability—it would be clear if the rules were being broken, and by whom. These constraints would also allow for a better assessment of managerial performance: simply, it would be easy to determine whether the Managing Director and/or Executive Board were violating the

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[32] In this case, quota will be determined by either calculated quota or a new quota formula that accurately assesses a member's economic importance, openness, etc.

[33] However, the IMF could still retain the ability to exceed access limits in highly unusual circumstances. Under this mechanism (and it would rarely be appropriate to invoke it), the Managing Director would need to appeal to a "notwithstanding" clause in order to override the access limit. The appeal would need to be formally presented to the Executive Board, which would then need to approve it. Executive Board decision making would not be by consensus, but by up/down voting, and a supermajority would be required. This exceptional access mechanism would allow the IMF to retain some flexibility while maintaining accountability.

[34] While the existence of preferred creditor status implies that no true credit risk exists, the occurrence of arrears in the past suggest that this approach is not entirely appropriate The IMF (2004) disputes the need for credit-risk measures.

[35] The adoption of risk-based credit measures would be consistent with the same governance standards that are applied, for example, to U.S. domestic banks, vis-à-vis the Federal Deposit Insurance Corporation (FDIC) Improvement Act (United States Congress 1991). For example, the FDIC Improvement Act states that "accounting principles applicable to reports or statements to be filed…should 'result in financial statements and reports of condition that accurately reflect the capital of such institutions'" (Section 37.a.1.A). This means that "risk-based assessments" (Section 302) are required such that risk is assessed based upon "different categories and concentrations of assets" (Section 302.b.1.C.i.I) and "the likely amount of any such loss" (Section 302.b.1.C.ii). These measures should also take account of "the risks of non-traditional activities" (Section 302.b.1.C.iii). As it currently stands, the IMF does not meet the accounting standards of the FDIC.

rules. It could also provide useful metrics against which to judge managerial performance.

Measuring the "success" of the Managing Director is less quantitatively tractable than the access limits and risk measures described above. Nevertheless, measuring the performance of the Managing Director in achieving program aims would be a key part of the Board's oversight role. For example, the Board would examine whether the Managing Director and the staff had correctly assessed the nature of a particular crisis through its surveillance function (that is, was the crisis local or systemically important), provided correct policy advice, and delivered a program that ultimately promoted the IMF's objectives without distorting private agents' behaviour.

The advantages of implementing a constrained discretion framework are clear: the objectives of the IMF would be set by the Executive Board, and then implemented by the Managing Director and the staff. The Executive Board would no longer make decisions by consensus; rather, transparent up/down voting would ensure accountability at their level of decision making. The delineation between the policies set out by the Executive Board and their implementation by the Managing Director would further enhance governance, since responsibility could be attributed accordingly. Overall, the combination of clearly defined objectives, responsibilities, operational rules, and transparency in how these rules are defined (through up/down voting) would greatly enhance the credibility and effectiveness of the IMF. This is due to the fact that, under this form of constrained discretion, the benefits and costs of policy design and implementation would be more fully internalized by the appropriate level of policy-maker.

8. Conclusion

The governance structure of the IMF was designed for an institution that would help to prevent, mitigate, and resolve the disruptions associated with balance-of-payments crises by offering temporary financing to a club of sufficiently homogeneous borrowers. Importantly, since its members could expect to be on either side of the balance sheet, the incentives of the IMF's members were closely aligned. Consequently, consensus decision making and the close interaction of the Executive Board and the Managing Director constituted a governance structure that was well suited to the IMF's tasks.

However, the world has changed considerably since the end of the Bretton Woods era. The small club of 44 countries has been superseded by a 184-member organization that includes both the richest and poorest countries in the world. The IMF now operates in a world of flexible exchange rates and highly integrated and sophisticated global capital markets, and has subsequently become a long-term lender to a group of serial borrowers. This evolution has coincided with the emergence of a distinct group of IMF creditors (developed countries) and IMF borrowers (emerging-market and developing countries), and countries that have flexible exchange rates and those that have fixed exchange rates, respectively.

The governance challenges of the IMF are numerous: voice, representation, transparency, accountability, program ownership, the enforcement of conditionality, and exceptional access limits, to name a few. While many of these issues are important, this paper has focused on the governance challenges with respect to the decision-making process of the IMF. I would suggest that even if the quota issue were to be resolved to the satisfaction of the IMF's membership, this would not necessarily mitigate the governance challenges confronting the IMF.

The IMF's decision-making process suffers from two potential governance failures: first, minority shareholders may have difficulty in resisting the actions of a controlling shareholder, and second, shareholders may have difficulty in resisting the initiatives that the Managing Director infers from the often heterogeneous interests of the Executive Board. While these governance issues are important, they are only parts of a larger challenge to IMF governance: the problem of accountability. The source of this lack of accountability lies within the consensus model of decision making, and the close working relationship between the Managing Director and the Executive Board. Moreover, the governance structure itself does not follow corporate best practice and renders internal change unlikely.

I recognize that instituting governance reform will be difficult given the challenges described above. Nevertheless, reforms are still possible. I propose to mitigate the governance problems of the IMF through the implementation of a modified form of constrained discretion. Under constrained discretion, the Executive Board would set out the objectives of the IMF, and the constraints under which it must operate.

Given the objectives and constraints set out by the Executive Board, the Managing Director and the staff would be free to use their "discretion" to achieve their goals. Much like the governor of a central bank operating under constrained discretion, the Managing Director would be free to pursue their goal with the tools they have been given.[36] Constrained discretion would thus ensure that the Managing Director would not deviate substantively from the limits imposed by the Executive Board. A fundamental part of the implementation of constrained discretion would be the removal of the Executive Board from the day-to-day operation of the IMF. Rather than sitting in a continuous session, the Board would meet only intermittently. For instance, the policy objective and constraints would be set yearly and the performance of the IMF reviewed quarterly. The advantage of separating the function of the Executive Board from the Managing Director is that accountability becomes more straightforward. Changes in the objectives and constraints would be directly attributable to the Executive Board, and the subsequent responsibility for policy implementation successes and failures would be assigned to the Managing

[36] Some critics have raised concerns that an independent Managing Director would have too much discretion, that too much responsibility would rest on one decision maker, and that small committees are often more effective than individual decision makers. I would argue that the actions of the Managing Director would be constrained by the rules set by the Executive Board. Also, the Managing Director would have the assistance of senior managers in making decisions.

Director. Also, the fiduciary duty of the Executive Board would be clarified – to ensure that the Managing Director is adhering to the constraints set out by the Executive Board.

This paper made clear the argument that the IMF's membership and program lending has changed dramatically since the end of the Bretton Woods era. Owing to these changes, the IMF's governance structure, as inherited from 1944, may not be appropriate given its changing role. The governance reforms suggested in this paper rest on the assumption that the current activities are the proper role for the IMF, and will remain so for the near future. The larger question that needs to be raised is whether these modest reforms will be appropriate given the role of the IMF in 2010. Simply, should the IMF continue its surveillance and program lending function, or are more radical changes needed for the future? For instance, many have argued that the IMF needs to take a leading role in surveillance of the international monetary system, particularly with respect to multilateral exchange rate surveillance. However, if the IMF wishes to fulfill this role as an "umpire," it will need to be impartial and independent of political interference. More generally, in order for the IMF to remain an effective international institution, its members must feel that the policies decided upon and implemented are consistent with the best economic analysis available, and not the result of an overly politicized decision-making process. The aim of this paper has been to highlight these governance challenges, and to propose reforms that ensure the legitimacy of the IMF as a truly international institution.

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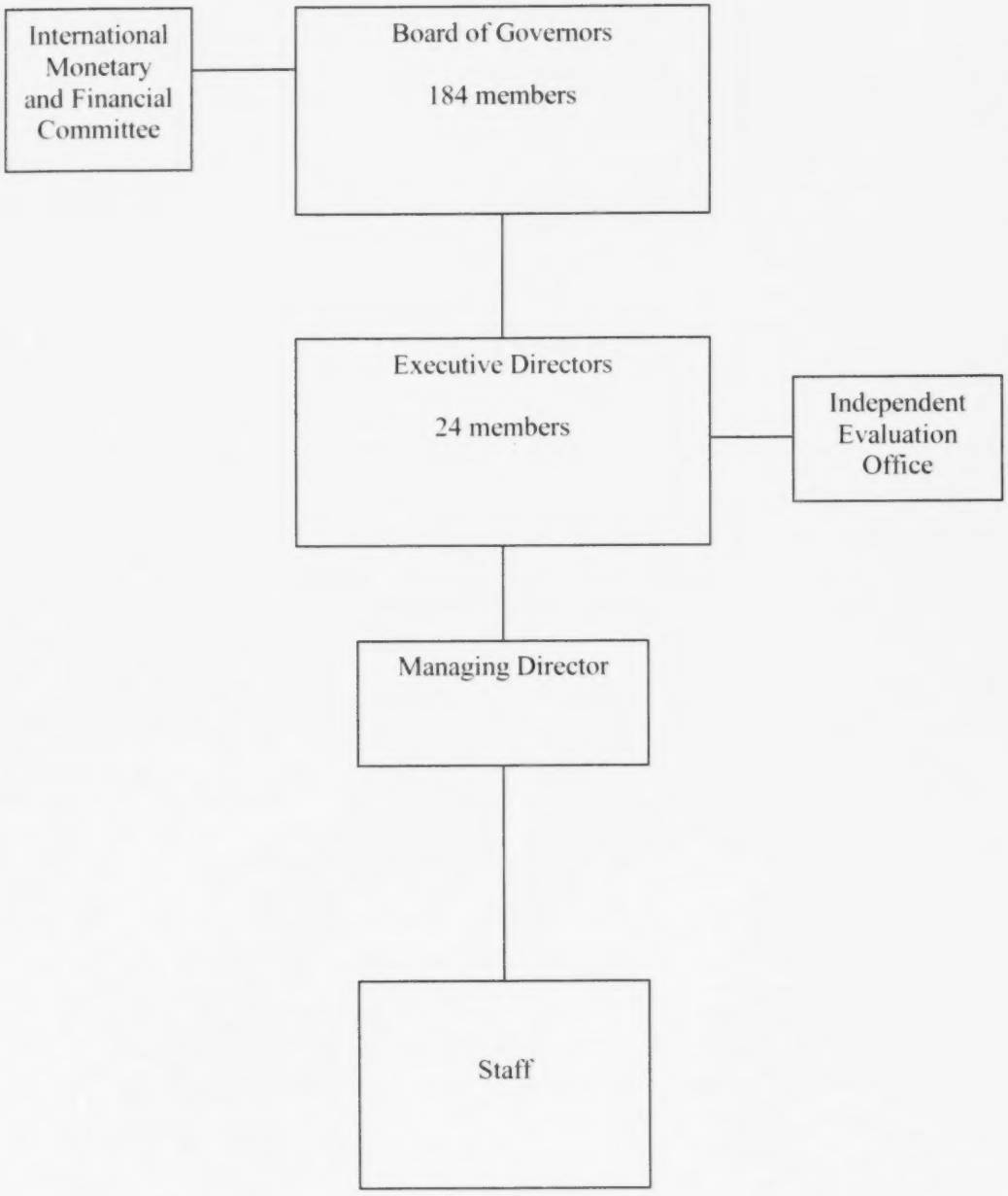
Figure 1: IMF Governance Structure



Source: IMF (2003)

Appendix: Gompers, Ishi, and Metrick (2003) Governance Index

Subindex 1: Delay

Provision 1: Classified (Staggered) Board – are directors placed into different classes and do they serve overlapping terms? Average: 59.4 per cent.
IMF Provision: There are different classes of directors and they are staggered. The largest five members by quota appoint their Executive Directors. For the rest, elections are held every two years, but IMF Board members are replaced at the discretion of the country groupings. Therefore, Directors may be staggered. Governance Index Score = 1.

Provision 2: Special meeting limitations – shareholder meetings require additional levels of support. Average: 34.5 per cent.
IMF Provision: A meeting requires the votes of fifteen members with 25 per cent of the voting power. A quorum is obtained only when a majority of the Governors with 2/3 of the voting power agree. Governance Index Score = 1.

Provision 3: Written consent – the need for unanimous consent. Average: 33.1 per cent.
IMF Provision: IMF has no such provisions. However, the consensus decision-making model implies that unanimity is achieved for all IMF decisions. Nevertheless, I assume that unanimous consent is not needed. Governance Index Score = 0.

Subindex 2: Protection

Provision 4: Director Indemnification Contracts – are directors immune to prosecution and lawsuits from shareholders, and will they have their legal fees covered? Average: 24.4 per cent.
IMF Provision: Articles state explicitly that directors are immune from "legal process" in carrying out their official duties (Article IX, Section 8 (i)), unless waived by the IMF. Governance Index Score = 1.

Provision 5: Liability – limits on directors' personal liability for breaches of duty of care (duty of loyalty). Average: 46.8 per cent.
IMF Provision: IMF Directors and top managers are not personally liable. Governance Index Score = 1.

Provision 6: Severance – assurance of position of executives does not depend on changes in control. Average: 11.7 per cent.
IMF Provision: Executive Board has the power to appoint and dismiss the Managing Director. Changes in authorities' governments are not correlated to changes in Managing Directors. Governance Index Score = 0.

Subindex 3: Voting

Provision 7: "Bylaw and Charter" measures the limitations on shareholders' ability to amend the governing amendments of the corporation. In practice, are supermajorities required or can the directors amend bylaws without shareholder approval? Average: 18.1 per cent.
IMF Provision: Qualified or "super" majorities are required on over 50 IMF decisions. This includes decisions on most other major governance issues. Supermajorities are typically 70 to 85 per cent. Governance Index Score = 1.

Provision 8: Lack of Secret Ballot: confidential voting is considered a positive for governance. Average: 9.4 per cent.
IMF Provision: Most decision making is done by informal consensus, which implies a weak form of secret voting. Governance Index Score = 0.5.

Provision 9: Supermajority – are supermajorities required? Average: 34.1 per cent.
IMF Provision: Supermajorities of 85 per cent or 70 per cent are required for most IMF business. Governance Index Score = 1.

Provision 10: Unequal voting rights – are some shareholders limited in their voting rights? Average: 1.9 per cent.
IMF Provision: Small countries that belong to country groupings are not directly represented, and therefore are represented only by the largest country. The misalignment of voting rights and quota from actual economic importance suggests that some shareholders have disproportionately more voting rights than others. For instance, Canada and China have the same share of voting rights, but China's GDP in PPP terms is six times larger than Canada's, and at market exchange rates is 60 per cent larger. Governance Index Score = 1.

Subindex 4: Other

Provision 11: Directors' Duties – do the provisions allow directors to consider the needs of constituents (such as private bond holders) other than shareholders? This allows directors to reject decisions that may have been beneficial to shareholders in favour of the constituency. Average: 4.4 per cent.
IMF Provision: Executive Directors are ultimately not accountable to all shareholders, only to their country authorities. Country authorities may have preferences regarding outside constituents. The process of consensus decision making renders accountability problematic, since decisions cannot be attributed specifically to individual directors. Governance Index Score = 1.

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